RABBIT EARS AND CREDIT RISK

by Steve Brown

Studies indicate 20% of all television viewing now happens online through the Internet. Whether you are watching television on your computer yet or not, that is a big number and it shows how much things can change even if you do not necessarily see them all coming.

Consider credit risk. It used to be a banker could make a loan to a borrower, some paperwork would be signed and the customer would pay their debts on time with interest. These days, credit quality is deteriorating, as past due, nonperforming loans and charge-offs increase. Perhaps that is why regulators are focusing specifically on a few key areas related to credit risk.

One of the most critical relates to how bankers calculate the allowance for loan loss reserve ("ALLL"). During this time of heightened uncertainty, it is crucial for bankers to develop, maintain and document a comprehensive and systematic approach to ALLL. Any such process must be consistently applied and bankers should pay particular attention to the size, nature, scope and risk of all lending activities when determining ALLL each month. Regulators have also indicated they want bankers to estimate credit losses by including all significant factors that might affect the collectibility of a loan.

In particular, when it comes to the ALLL calculation, bankers should be sure historical loss experience is only a starting point. When it comes to calculating reserves, historical losses and even recent trends in losses, these factors do not alone form a sufficient basis to determine the appropriate ALLL. The fact is that bankers should be sure to consider and include qualitative or environmental factors as well, since these could cause estimated credit losses to differ from historical loss experience. When we say environmental factors, we are talking about changes to the economic/business environment, policies, underwriting standards and even changes in the volume/severity of problem loans. In short, if the environment around the bank is experiencing declining credit-quality trends, the bank should assess why these issues have not yet visited them (in the form of interest reserves, extensions, etc.). Doing so ensures the bank has a good handle on risk and that the ALLL level, as a percentage of the portfolio, is generally increasing as deterioration outside increases.

Another key area of credit risk we suggest bankers focus on relates specifically to real estate loans. Regulators have told bankers they are very focused on exposures in this sector and as a result, community banks have increased reserves and attention in this area. The massive slowdown in housing has bled through to weakness in construction, increased inventories of unsold homes and led to higher mortgage foreclosures. That is a key reason why community banks have ramped up risk management and in depth analysis related to these sectors in the past year.

Improving risk management in the real estate sector is a good idea right now, but it does not have to be significantly complex. It can begin with just knowing where regulators are focused and developing programs to analyze and report on those areas in more detail. Portfolio analysis and stress testing are good places to begin. To do so, bankers should analyze not only current conditions, but also a myriad of potential future scenarios. This will provide a basis for contingency planning and serve as a roadmap in the event stress scenarios actually occur. Along similar lines, bankers should ensure they have a credible plan for a loan to pay off, before increasing interest reserves or making other accommodations (on construction loans in particular). Doing so avoids the wrath of the regulators and improves underlying loan analysis. In general and at a minimum, we suggest banks monitor the performance of the loan portfolio through concentration, market and portfolio stress testing.

While it is still hard to believe that as of February 17, 2009, rabbit ear and rooftop antennas will no longer be needed. Change can be good, but we also wonder how long it will take some people to tear the antenna off their chimney.

REGULATORY DEADLINE UPDATE - TCPP & TLGP

To help clear up the confusion and given that deadlines are fast approaching, here is the latest update on these programs: 1. Treasury Capital Purchase Program ("TCPP"): All publicly traded eligible institutions wishing to participate must submit their applications no later than 5:00 p.m. ET, this Friday, November 14. For privately held institutions, an application form and term sheet will be posted at a later date and a reasonable deadline to apply will then be established. 2. FDIC Temporary Liquidity Guarantee Program ("TLGP"): All eligible institutions are covered unless they opt out of one or both of the components (debt guarantee component or transaction account guarantee) by December 5, 2008.

BANK NEWS

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Commerce Bancorp ($2.1B, PA) will acquire Republic First ($965mm, PA) for an all stock transaction valued around $124mm or 1.34x book. The new entity will change its name to Metro Bank.

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Independent Bank ($3.5B, MA) will acquire Benjamin Franklin Bancorp ($981mm, MA) for $125mm or 1.14x book.

Downey Savings

The $13B Los Angeles-based thrift said there is "substantial doubt" about its ability to stay in business and "significant risk" the "bank will not be able to raise sufficient capital" to ensure compliance with capital requirements of regulators.